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**WASHINGTON**

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## CABINET AFFAIRS STAFFING MEMORANDUM

**Date:** 1/4/84      **Number:** 168869CA      **Due By:** \_\_\_\_\_

**Subject:** Cabinet Council on Economic Affairs - January 5, 1984

8:45 a.m. - Roosevelt Room      **TOPIC:** Financial Market Developments

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	McFarlane	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input checked="" type="checkbox"/>	<input type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/	<input type="checkbox"/>	<input type="checkbox"/>
EPA	<input type="checkbox"/>	<input type="checkbox"/>	CCHR/Simmons	<input type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>	CCLP/Uhlmann	<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>	CCMA/Bledsoe	<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCNRE/	<input type="checkbox"/>	<input type="checkbox"/>

**REMARKS:**

The Cabinet Council on Economic Affairs will meet on Thursday, January 5, 1984 at 8:45 a.m. in the Roosevelt Room.

An additional background paper is attached.

**RETURN TO:**

☐ Craig L. Fuller  
Assistant to the President  
for Cabinet Affairs  
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☐ Katherine Anderson  
☒ Tom Gibson

Associate Director  
Office of Cabinet Affairs  
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☐ Don Clarey  
☐ Larry Herbolsheimer

DCI  
EXEC  
REG

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THE WHITE HOUSE  
WASHINGTON

January 3, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*  
SUBJECT: Additional Paper for the January 5 Meeting

A paper from William Poole entitled "Financial Markets Update" for the January 5 meeting of the Cabinet Council on Economic Affairs is attached. This paper supplements the two monetary policy papers also prepared for this meeting.

Attachment

COUNCIL OF ECONOMIC ADVISERS  
WASHINGTON, D C 20500

MARTIN FELDSTEIN, CHAIRMAN  
WILLIAM A. NISKANEN  
WILLIAM POOLE

January 3, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC POLICY

FROM: William Poole W.P.  
SUBJECT: Financial Markets Update

There has been a significant change in the tone of the financial markets over the last ten weeks or so. Long-term interest rates rose somewhat in October, and money market rates in November; the stock market has traded in a relatively narrow range since September. However, these changes in securities prices are well within the range of normal fluctuation.

More interesting is the changed market attitude toward monetary policy. Until mid-November or so there was a growing view that the next policy adjustment by the Federal Reserve would likely be in the direction of nudging interest rates down. Money growth was well controlled--indeed, M1 was approaching the bottom of its 5 to 9 percent growth range--and many interpreted incoming data on the real economy as suggesting that the upward momentum was slowing.

In recent weeks the incoming economic data have remained mixed; some indicators suggest a slowing of the expansion and others suggest continuing rapid growth. Some analysts have interpreted Federal Reserve policy actions and statements as suggesting Fed concern over the possibility of excessive strength in the economy that might lead to a resurgence of inflation in 1984. With this change in tone, the market ceased to expect that the Federal Reserve might ease interest rates down in the near future; moreover, at times there has been increasing speculation that the Fed may actually be pushing rates higher. This changed tone occurred even though money growth continued to be slow, bumping along at the bottom of the Fed's 5 to 9 percent target range.

Interest Rates and Stock Prices

Chart 1 shows recent behavior of interest rates, long and short, against the background of experience since 1970. There is no reason to believe that the minor backing up of rates in recent weeks indicates any major reversal of the gains achieved in bringing rates down over the past few years.

Chart 2 provides similar information on the stock market. It is worth noting that the stock market is a far better predictor of business developments than is the bond market. When stock prices and interest rates are both rising, the

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probable explanation is that the business outlook is good. Stock prices rise because corporate profits are expected to rise; interest rates rise because a strong economy generates rising credit demands to finance housing, cars, and business investment.

Stock prices, though down slightly from their highs, suggest that business activity will remain strong in 1984. The Standard and Poor's composite index reached a weekly peak of 170 in October, essentially the same as the June peak; in the last week of December this index stood at 165. The business outlook would change, however, if recent slow money growth were to continue for another three months.

### Money Growth and Velocity

As noted above, the rate of growth of M1 has declined significantly. In the latest week for which data are available, M1 was about 5 percent annual rate above its second quarter average. As can be seen from Chart 3, the slow growth in M1 after July cancelled out high growth in the spring and early summer. The annual rate of growth of M1 was 3.1 percent from July to December, compared to 14.5 percent over the 12 months ending July. This deceleration in money growth is the largest since the Korean War.

In judging the appropriate rate of money growth the key uncertainty is the future behavior of velocity. Given that GNP reacts with a lag to changes in money growth, it is most useful to measure velocity by dividing GNP one quarter by the money stock two quarters earlier. Using an estimate for the quarterly average of M1 in 1983:IV and the Blue Chip consensus forecast for GNP over the first half of 1984, M1 velocity will be rising sharply. This rebound, assuming that it occurs, will offset some of the sharp decline in velocity that occurred in 1982 and early 1983. Chart 4 provides a perspective on these developments.

There is no way of knowing for certain how far the velocity rebound will go. However, a reasonable best guess might go something like this. If money growth were to average about 5 percent, we might expect velocity increases averaging 4 to 5 percent next year. These increases would reflect the trend rate of velocity increase of about 3 percent plus a normal cyclical rebound of 1 to 2 percent. Those numbers fit in comfortably with the Administration's forecast of 9.7 percent growth in nominal GNP. Money growth at the top end of the Fed's range--9 percent--would probably be excessive. Growth at that rate would be appropriate only if velocity were likely to show little change. But, as suggested by the chart, velocity growth seems to be resuming.

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Velocity growth of 4 to 5 percent is, it seems to me, the most reasonable planning assumption for monetary policy. However, I confess to a nagging feeling that velocity will in fact increase more rapidly than that, reflecting a snap-back rather than a gradual erosion of the large decline in velocity in 1982. But even with such a view I would argue strongly against a policy of lower money growth to offset anticipated higher velocity growth. Economists have a long record of failure in fine-tuning policy to reflect shaky estimates such as these. Now is the best time to get off the fine-tuning roller coaster by adhering closely to announced targets for moderate money growth.

Chart 1

# RATE ON 3-MONTH T-BILL AND 20-YEAR GOVT BOND

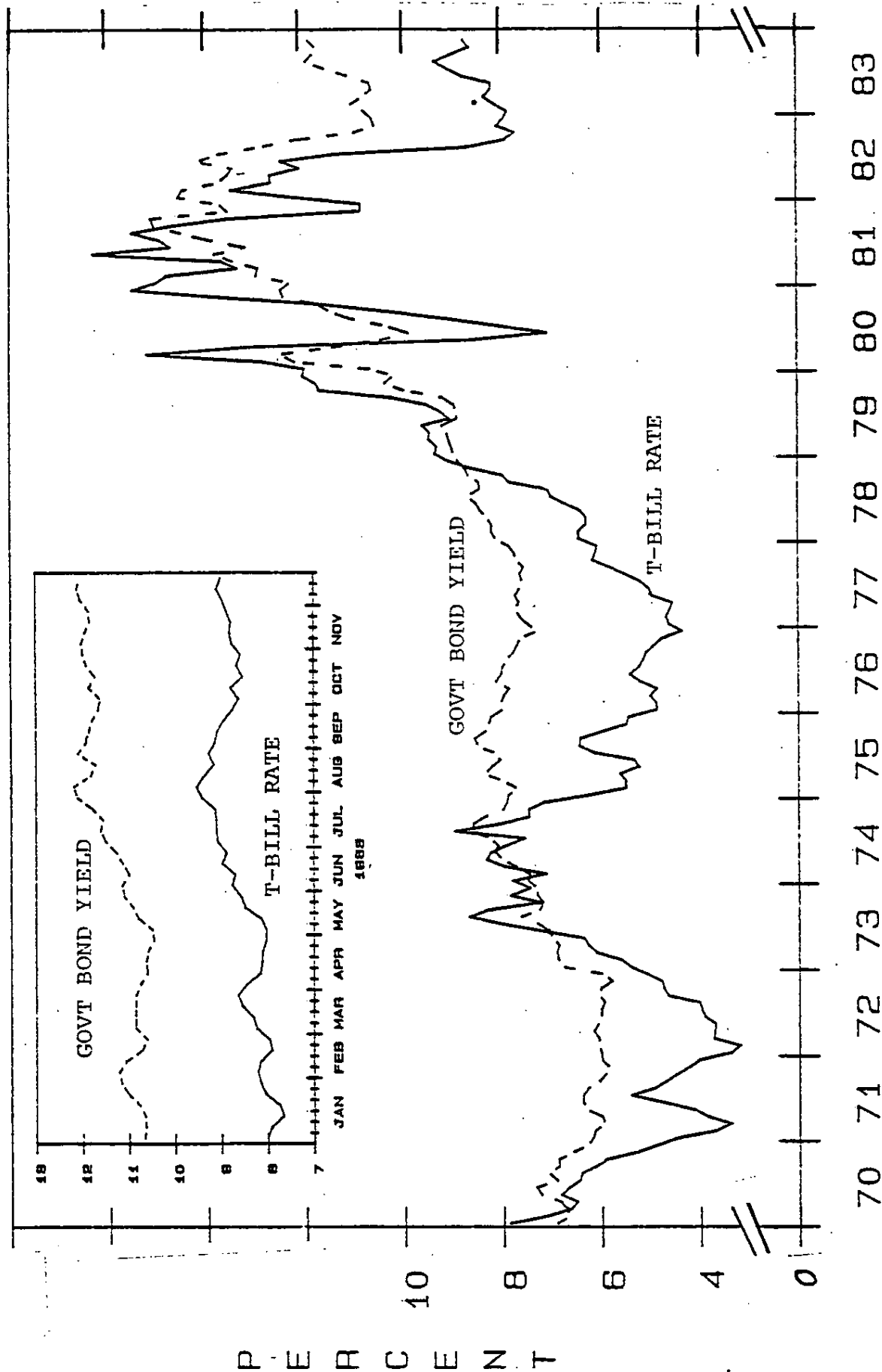


Chart 2  
STANDARD & POOR'S 500 INDEX

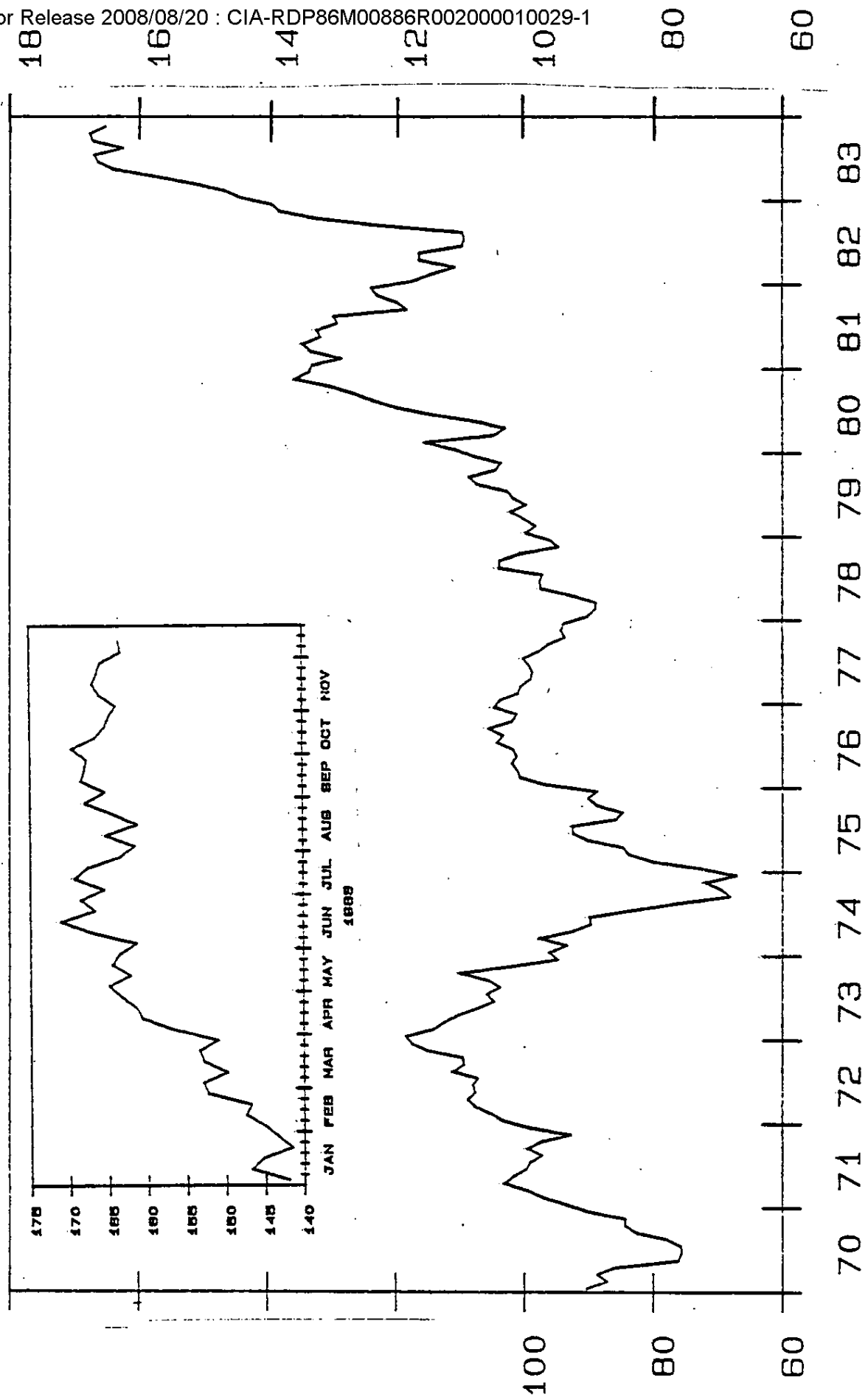


Chart 3  
M1 Versus Target Range  
Weekly Averages - Seasonally Adjusted

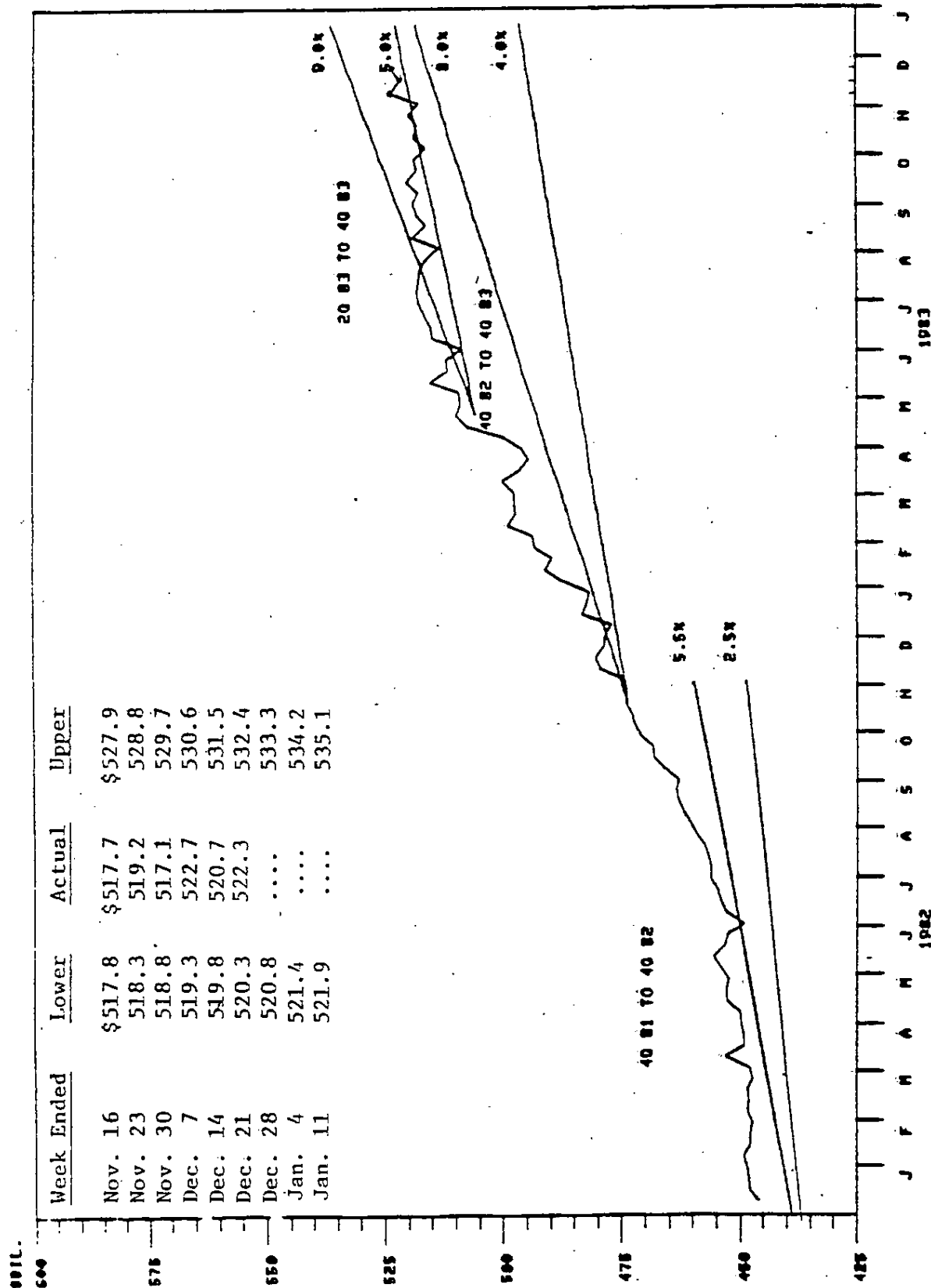




Chart 4  
MONETARY VELOCITY  
VELOCITY =  $GNP/M1 (-2)$

